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No. 97-1717

In the Supreme Court of the United States

OCTOBER TERM, 1997

THOMAS E. BENNETT, JOAN A. BENNETT, THEODORE BLACK AND MARILYN BLACK, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

BRIEF FOR THE RESPONDENT IN OPPOSITION

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QUESTION PRESENTED

Whether, on the particular facts of this case, petitioners are liable for the negligence penalty imposed by Section 6653(a) of the Internal Revenue Code, 26 U.S.C. 6653(a) (1982).

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OPINIONS BELOW

The order of the court of appeals (Pet. App. 1a-2a) is unpublished, but the decision is noted at 131 F.3d 130 (Table). The opinion of the United States Tax Court (Pet. App. 3a-32a) is unofficially reported at 71 T.C.M. (CCH) 1737.

JURISDICTION

The order of the court of appeals was entered on December 26, 1997. On March 10, 1998, Justice Ginsburg extended the time for filing a petition for a writ of certiorari to April 27, 1998. The petition for a writ of certiorari was filed on April 21, 1998. The jurisdiction of this Court is invoked under 28 U.S.C. 1254(1).

STATEMENT

Section 6653(a) of the Internal Revenue Code imposes a penalty of five percent on any tax underpayment resulting from the "negligence" of the taxpayer. 26 U.S.C. 6653(a) (1982). The courts below both concluded that, on the particular facts of this case, petitioners were negligent in the underpayment of their tax obligations.

1. a. On their income tax returns for 1981, petitioners improperly claimed income tax deductions and credits from their participation in a tax shelter scheme involving a limited partnership known as Empire Associates. That partnership was formed to promote the plastics recycling tax shelter described in *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) 2531 (1992), aff'd mem., 996 F.2d 1216 (6th Cir. 1993), cert. denied, 510 U.S. 1163 (1994).

This tax shelter involved a series of simultaneous sales, leases and licenses of machines designed to recycle plastic scrap (Pet. App. 8a). In 1981, Packaging Industries, Inc., manufactured and sold seven recyclers to ECI Corp. for $6,867,000, of which only $533,000 was paid in cash. ECI Corp. resold the recyclers to F & G Corp. for $8,138,667 ($1,162,666 each), of which only $618,000 was paid in cash. F & G Corp. then leased the recyclers to Empire Associates, which licensed them to FMEC Corp. That corporation then completed the circle by sublicensing the recyclers back to their original manufacturer, Packaging Industries, Inc. The monthly payments required among the entities involved in these transactions precisely offset each other—no cash changed hands (Pet. App. 7a). These circular transactions thus constituted a classic sham and tax shelter

scheme; they lacked any economic substance or business purpose *other than* the ostensible creation of tax deductions and credits. See *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) at 2547-2553.

The prospectus for the tax shelter scheme contained direct warnings of the tax risks presented by these sham transactions (J.A. 453):

> AN INVESTMENT IN THE PARTNERSHIP INVOLVES A HIGH DEGREE OF BUSINESS RISK AND SOME TAX RISKS AND SHOULD, THEREFORE, BE CONSIDERED ONLY BY PERSONS WHO * * * CAN AFFORD TO LOSE ALL OF THEIR CASH INVESTMENT AND SOME OF THEIR ANTICIPATED TAX BENEFITS.

The prospectus emphasized that the partnership had no operating history and that there was no established market for the recycling machines. As the trial court stated (Pet. App. 20a-21a) (emphasis added):

> [T]he Empire transaction should have raised serious questions in the minds of ordinarily prudent investors. According to the offering memorandum, the projected benefits for each $50,000 investor were investment tax credits in 1981 of $86,328 plus deductions in 1981 of $39,399. In the first year of the investment alone, petitioners each claimed an operating loss in the amount of $20,510 and investment tax and business energy credits related to Empire totaling $42,402, while petitioners each invested only $25,000 in Empire. *The direct reductions in petitioners' respective Federal income taxes, from just the tax credits, equaled 170 percent of their cash investment.*

The prospectus directly warned participants that, in view of the sizeable tax benefits claimed, the Internal Revenue Service would probably audit the income tax returns of the partnership and its partners (J.A. 474-475).

A tax opinion prepared by an attorney was attached to the prospectus (J.A. 565-629). The attorney acknowledged that he lacked a technical background and did not have a good understanding of engineering or of the development and design of the recycling machine (J.A. 787). His tax opinion was addressed to the general partner of Empire Associates, Richard Roberts. The opinion stated that it was for the "individual guidance" of Mr. Roberts and that investors should rely on their own advisors (J.A. 565).[1] Although the amount of any tax benefits to be realized from the transactions depended on the proper valuation of the recyclers, the attorney did not make or offer any personal valuation of that equipment. He merely cited "[t]he written evaluation of the Sentinel Recyclers furnished to the Partnership by one Evaluator [who] concludes that the purchase price to be paid by F & G therefor is fair and reasonable" (J.A. 585).[2] Although the attorney concluded that the tax

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[1] The prospectus similarly warned participants that "NO OFFEREE SHOULD CONSIDER THE CONTENTS OF THIS MEMORANDUM * * * AS * * * EXPERT ADVICE" and that "EACH OFFEREE SHOULD CONSULT HIS OWN PROFESSIONAL ADVISERS" (Pet. App. 19a-20a).

[2] The evaluator referenced in the attorney's opinion was Stanley M. Ulanoff, a Professor of Marketing at the School of Business of the City University of New York (J.A. 640). His "evaluation" consisted primarily of a discussion of the need for plastics recycling (J.A. 638-648). He did not do a marketing analysis and did not analyze the costs or anticipated revenues

benefits sought by the partnership would probably be achieved, his opinion emphasized that "the Service is not bound by and may challenges the conclusions reached in such report" (*ibid.*).

b. During the period of their investment in Empire Associates, petitioners Thomas Bennett and Theodore Black were vice-presidents of the Ingersoll-Rand Co. That company manufactures machinery such as construction equipment, pumps, air compressors, rock drills, pneumatic tools and bearings (Pet. App. 7a, 11a). In 1981, one of Ingersoll's subsidiaries manufactured plastic injection molding equipment that used the same type of pellets produced by the recycler used in the tax shelter scheme (*id.* at 11a, 21a).

Petitioners are engineers and both have attended the advanced management program at Harvard University (Pet. App. 10a). Between 1951 and 1968, petitioner Bennett was involved in marketing at Ingersoll-Rand and "continuously dealt with product pricing" (*ibid.*). By 1978, he had become vice president in charge of strategic planning for Ingersoll-Rand and was responsible for merger and acquisition analyses for the company (*ibid.*).

Petitioner Black ultimately became Ingersoll's chairman and chief executive officer. He previously had been an account manager, general manager, district manager and vice-president of the company (Pet.

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from the recycler. Indeed, he did not refer in his "evaluation" to the ostensible purchase price ($1,162,666) of the recycler involved in this tax shelter scheme and, so far as can be determined from reviewing his report, was unaware of it. Another purported "evaluator" was a mathematics professor named Samuel Burstein. He concluded only that the equipment was operationally reliable and did not purport to determine the value of the equipment (J.A. 668).

App. 7a, 11a). Black, like Bennett, was an expert in product pricing (J.A. 307-310). He testified that he "kn[e]w a lot about what machinery costs" and "was very familiar with high priced special machinery" because "[t]hat's how [he] made [his] career in machinery" (J.A. 338).

Petitioners learned of the plastics recycling tax shelter from Edward Gallagher, an officer of Bankers Trust. (Pet. App. 8a). Gallagher, who had a bachelor of arts degree, toured a plant where the recyclers were in operation. He summarized his observations in a memorandum circulated to petitioners and other Ingersoll executives. His memorandum was prefaced with the statement that he did "not have an engineering background" (*id.* at 9a). He testified at trial that he expected petitioners to make their own judgments of the value of the recyclers because they were engineers and had better resources to ascertain the value of machinery (*id.* at 18a). He testified that the Ingersoll officers "absolutely" understood that they could not rely on him to determine the value of the recyclers (*ibid.*).

Petitioners, however, made no independent investigation or evaluation of the recyclers (Pet. App. 19a). Although they had ready access to the relevant information, they made no attempt to determine the *bona fide* value of the recyclers or their economic viability (*id.* at 23a).

Petitioners each invested $25,000 in the tax shelter scheme in 1981. Both then claimed an immediate operating loss of $20,510 and an investment tax credit

of $42,402 on their 1981 tax returns (Pet. App. 7a).[3] The investment tax credit was based on an alleged value of $1,162,666 per recycler (*id.* at 21a). The Commissioner disallowed the claimed tax benefits and asserted that petitioners were liable for penalties for negligence (26 U.S.C. 6653 (1982)) and for valuation overstatement (26 U.S.C. 6659 (1982)).

2. Petitioners sought review of the Commissioner's determinations in Tax Court. Prior to trial, petitioners stipulated that the fair market value of the recyclers did not exceed $50,000 in 1981 and that their limited partnership transactions lacked economic substance (Pet. App. 21a; J.A. 115, 145). They therefore conceded that they were not eligible for the claimed operating loss deductions and tax credits that they had claimed on their returns (Pet. App. 5a). They continued to assert, however, that they were not liable for the negligence penalty for claiming these improper deductions and credits.

The Tax Court sustained the negligence penalty and rejected petitioners' assertion that they had reasonably relied on expert advisors to determine the value of the recyclers (Pet. App. 13a-26a).[4] At trial, Bennett had admitted that he was better qualified than those on whom he allegedly relied to evaluate the plastics recycler (J.A. 236):

> THE COURT: * * * I'm puzzled that you relied upon a banker, a lawyer that was no

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[3] The Bennetts were unable to utilize the entire amount of the tax credits on their 1981 return. They sought to carry the asserted credits back to their 1978 and 1979 tax years (J.A. 89).

[4] The Tax Court also sustained the valuation overstatement penalty under 26 U.S.C. 6659. Petitioners no longer challenge the imposition of that penalty.

> engineer by his own admission in stipulated testimony, and your company's financial people with respect to a machine which you personally probably could have evaluated and analyzed better than these financial types.
>
> Why didn't you go look at it, or get somebody with a technical background to look at this machine for you?
>
> THE WITNESS: Well, Your Honor, I would say retrospectively that would have been a smarter thing to do.

Black similarly acknowledged that his asserted reliance on others to determine the value of the recyclers was, "in hindsight, not very brilliant" (Pet. App. 20a).

The court concluded that the express warnings in the prospectus concerning the tax risks, and the implausibly disproportionate tax benefits of the shelter scheme, would have alerted any prudent investor to the questionable nature of the project (Pet. App. 19a-21a). The court pointed out that the immediate tax credits claimed by petitioners were almost twice as great as the cash outlays required by the shelter scheme (*id.* at 21a). The court refused to credit the suggestion that petitioners relied heavily on Gallagher and concluded that any such reliance would have been unreasonable in light of the fact that petitioners had personal expertise in valuing machinery and had personal access to the information needed to determine the value of the recyclers. The court emphasized that (*id.* at 25a):

> the record in these cases, including the testimony of Black and Bennett and their manner in presenting that testimony, establishes that they are

men of education, experience, and talent in the business of manufacturing and selling machinery, that during the time in issue they were senior executives of a large machinery manufacturing company, that they were highly knowledgeable about appropriate pricing for a great variety of machinery, that they had the ability and resources to learn the value of the machinery involved in the Empire plastics recycling venture, in which they invested, and that they could have obtained such information without undue expense or effort.

3. The court of appeals affirmed the imposition of the negligence penalty "for substantially the reasons stated" in the Tax Court opinion (Pet. App. 2a).

ARGUMENT

The decision of the court of appeals is correct and does not conflict with any decision of this Court or any other court of appeals. Further review is therefore not warranted.

1. For purposes of Section 6653, "negligence" is the lack of due care or failure to do what a reasonable and prudent person would do under similar circumstances. *Anderson* v. *Commissioner*, 62 F.3d 1266, 1270 (10th Cir. 1995). Whether a taxpayer is negligent is an inherently factual inquiry that depends, in part, on his education, intelligence, and sophistication. See, *e.g.*, *David* v. *Commissioner*, 43 F.3d 788, 789 (2d Cir. 1995); *H.G.A. Cinema Trust* v. *Commissioner*, 57 T.C.M. (CCH) 1066, 1072 (1989), aff'd, 950 F.2d 1357 (7th Cir. 1991), cert. denied, 505 U.S. 1205 (1992); *Heasley* v. *Commissioner*, 902 F.2d 380, 381 (5th Cir. 1990). The fact that a taxpayer has sought and obtained professional advice in connection with a transaction does not insulate him from the negligence

penalty. Good faith reliance on the advice of a qualified independent professional can, however, show that a taxpayer exercised due care. *United States* v. *Boyle*, 469 U.S. 241, 252 (1985); *Betson* v. *Commissioner*, 802 F.2d 365, 371 (9th Cir. 1986). The taxpayer's reliance must, of course, be reasonable in the circumstances. *Goldman* v. *Commissioner*, 39 F.3d 402, 408 (2d Cir. 1994); *Hanson* v. *Commissioner*, 696 F.2d 1232, 1234 (9th Cir. 1983).

The courts below properly conducted the factual analysis required to determine whether petitioners acted with due and reasonable care. The finding of negligence in which both courts concurred is supported by the overwhelming weight of the evidence.[5] The prospectus, which was replete with warnings of business and tax risks, should have alerted petitioners to the questionable nature of the extraordinary tax benefits projected by the tax shelter scheme. Petitioners, who had engineering degrees and were vice-presidents of a machinery manufacturer, were experts in pricing machinery. They knew that their advisors lacked technical expertise and admitted that they could have evaluated the recycler better than their advisors (Pet. App. 18a, 20a). Further, they had "ready access to * * * an Ingersoll-Rand subsidiary involved in plastics and which Bennett believed used pellets like those produced by the * * * recycler" (*id.* at 16a). They could

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[5] The factual nature of the question presented is demonstrated by the fact that the Tax Court has concluded that some of the investors in this tax shelter scheme were *not* negligent. See, *e.g.*, *Zidanich* v. *Commissioner*, 70 T.C.M. (CCH) 367 (1995) (unsophisticated investors reasonably relied on the advice of others and were not liable for the negligence penalties).

have used this resource to obtain further information about the recycler.

The courts below also correctly rejected the contention that petitioners had reasonably relied on others in evaluating the shelter scheme. As the Tax Court concluded, petitioners were not primarily influenced by the advice of a professional advisor in determining the value of the recyclers, and any reliance on such advisors for that purpose would have been unreasonable in view of the lack of technical expertise on the part of the advisors to make such an appraisal (Pet. App. 14a, 18a).[6]

The factual determinations that petitioners acted without due care and without reasonable reliance on the advice of others are not clearly erroneous. There is no basis to disturb these findings "concurred in by two lower courts" (*Rogers* v. *Lodge*, 458 U.S. 613, 623 (1982)). See *Tiffany Fine Arts, Inc.* v. *United States*, 469 U.S. 310, 317-318 n.5 (1985). Moreover, a challenge to such findings is not a suitable basis for obtaining review of the decision below in this Court. Sup. Ct. R. 10.

2. a. Petitioners plainly err in relying (Pet. 13) on the statement in *United States* v. *Boyle*, 469 U.S. at 251, that "[w]hen an accountant or attorney *advises* a taxpayer on a matter of tax law, such as whether a liability exists, it is reasonable for the taxpayer to rely on that advice." The issue with respect to which petitioners were negligent in this case does not involve any reliance on an opinion of an attorney with respect to a question "of tax law" (*ibid.*).

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[6] Moreover, the attorney's opinion expressly stated that it was for the guidance of the general partner only and that individual investors were not to rely on it (J.A. 565, 585).

The key to the tax benefits claimed by the tax shelter scheme involved in this case was the highly inflated price paid for the recycler. As the Tax Court emphasized, "[i]t was petitioners' reliance upon the purported values of the Sentinel EPE recyclers that generated the deductions and credits in these cases" (Pet. App. 18a). Neither the banker nor the attorney on whom petitioners claim to have relied purported to validate the price of the recyclers. As the Tax Court concluded, although an attorney may be capable of giving expert advice on a question of tax law, "it is not reasonable or prudent to rely upon an adviser regarding matters outside of his field of expertise or with respect to facts which he does not verify" (*id.* at 19a).

b. Petitioners are similarly incorrect in asserting that "the Tax Court's holding that a taxpayer is subject to the negligence penalty unless he obtains the advice of an expert who is knowledgeable in the technology" conflicts with decisions of the Fifth and Tenth Circuits (Pet. 10). The actual conclusion of the Tax Court is that the particular advisors on whom petitioners claimed to rely *were not* expert on the factual issue of valuation involved in this case—and that petitioners therefore did not reasonably rely on those advisors for that purpose (if, indeed, they relied on them at all for that purpose). See Pet. App. 19a. That conclusion is not even remotely similar to the broad proposition that petitioners attempt to make the basis for the alleged conflict.

That factual conclusion of the courts below does not conflict with the decisions of the Fifth and Tenth Circuits on which petiitoners rely. In *Anderson* v. *Commissioner*, 62 F.3d 1266 (10th Cir. 1995), the Tenth Circuit upheld the Tax Court's finding of

negligence on the ground "that a reasonable investor who was buying $124,500 worth of property for its long-term income producing potential would have done more to verify that the property actually existed and was actually producing or capable of producing income" than did taxpayers. *Id.* at 1272-1273. The court of appeals added that, if taxpayers had "conducted a reasonable investigation, * * * they would have learned that the GD & L container program was a sham and that they were not entitled to the deductions and credits they claimed for the investment." *Id.* at 1273. The court's further observation that "one does not have to be an expert in an industry before he can invest in the industry himself or recommend an investment to another" (*id.* at 1271) is manifestly not in conflict with any conclusion of the courts below in this case.

Similarly, *Chamberlain* v. *Commissioner*, 66 F.3d 729 (5th Cir. 1995), rev'g in part 67 T.C.M. (CCH) 2992 (1994), and *Durrett* v. *Commissioner*, 71 F.3d 515 (5th Cir. 1996), rev'g in part 67 T.C.M. (CCH) 2735 (1994), do not involve investors who were more knowledgeable than their advisors on the factual issues of importance in the negligence determination. In both of those cases, the taxpayers had engineering backgrounds but had no familiarity with forward contracts to purchase and sell mortgage-backed securities, which was the subject of the tax shelter in which they invested. 67 T.C.M. at 2742, 2994. In that circumstance, the Fifth Circuit found it reasonable for taxpayers to rely on advisors who were more knowledgeable of such transactions. In the present case, by contrast, petitioners acknowledged that they were *more* knowledgeable than their advisors on the critical factual issues and that they were aware of the

limitations of their advisor's expertise. See pages 7-8, *supra*.

Several courts of appeals have upheld the decisions that have imposed negligence penalties in connection with the claimed tax benefits from the plastics recycling tax shelter scheme.[7] See *Spears* v. *Commissioner*, 72 T.C.M. (CCH) 223 (1996), aff'd mem., 131 F.3d 131 (2d Cir. 1997) (Table); *Provizer* v. *Commissioner*, 63 T.C.M. (CCH) 2531 (1992), aff'd mem., 996 F.2d 1216 (6th Cir. 1993), cert. denied, 510 U.S. 1163 (1994); *Estate of Busch* v. *Commissioner*, 72 T.C.M. (CCH) 242 (1996), aff'd mem. *sub. nom. Snyder* v. *Commissioner*, 81 A.F.T.R.2d (RIA) 98-1279 (2d Cir. Mar. 12, 1998); *Morgan* v. *Commissioner*, 72 T.C.M. (CCH) 524 (1996), aff'd, No. 97-4599 (11th Cir. Mar. 9, 1998). There is thus no conflict among the circuits nor other reason to warrant review of the decision in this case.

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[7] In *Farrell* v. *Commissioner*, 136 F.3d 889 (2d Cir. 1998), the court of appeals held that the Tax Court had abused its discretion in permitting the Commissioner to amend his answer to assert additions to tax under 26 U.S.C. 6653 and 6659, when these additions were not asserted in the notice of deficiency and when the parties had stipulated that the only issues remaining in dispute were an adjustment of $20,050 and the disallowance of an investment tax credit.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted.

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